

Tax Type: Income Tax
Issue: Reasonable Cause on Application of Penalties

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	
)	Docket No. 02-IT-0000
v.)	FEIN 00-0000000
)	
ABC, INC.)	
)	
)	Claim for Credit or Refund
Taxpayer)	

Appearances: Kent Steinkamp, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Phillip H. Hamilton of Farrell, Hunter, Hamilton & Julian, P.C. for ABC, Inc.

On August 2, 2001, ABC, Inc. (“taxpayer”) filed amended income tax returns that requested refunds of penalties that were imposed for 1996 and 1998. On October 4, 2001, the Department of Revenue (“Department”) issued Notices of Denial of the claims for refund. The taxpayer timely protested the Notices of Denial. The parties have filed a stipulation of facts and briefs in support of their positions. The taxpayer has asked that the penalties be abated because (1) they were improperly imposed or (2) reasonable cause warrants their abatement. The parties have asked that this matter be resolved based on

their written submissions. After reviewing the documents, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. On March 16, 1998, following an audit of the taxpayer's federal tax returns for 1995 and 1996, the IRS notified the taxpayer that it owed the federal government an additional \$24,875.23 for 1995 and \$269,739.87 for 1996. (Stip. #14)

2. As a result of this federal change, the taxpayer was required to file amended Illinois income tax returns for 1995 and 1996 within 120 days of March 16, 1998, which would be July 14, 1998. (Stip. #14)

3. On May 26, 1998, the taxpayer filed its 1997 Form IL-1120, claiming a net operating loss ("NOL") of \$789,942. The return also claimed an overpayment of 1997 estimated tax payments in the amount of \$55,000. (Stip. #32)

4. On July 14, 1998, the Department sent the taxpayer a letter indicating that amended Illinois income tax returns were due that day for 1995 and 1996 because of the federal change. (Stip. #15)

5. On July 19, 1998, the taxpayer's accountant responded to the letter and acknowledged that amended returns needed to be filed and that the taxpayer was in the process of completing the returns. (Stip. #16)

6. On August 26, 1998, the taxpayer filed amended Illinois income tax returns for 1995 and 1996. The taxpayer owed \$3,830 on the 1995 return and \$51,983 on the 1996 return. No payment was enclosed with the mailing of these amended returns. (Stip. #17, 36)

7. On September 1, 1998, the Department sent a letter to the taxpayer that acknowledged receipt of the amended returns. The Department stated that the returns would be reviewed on a first in first out basis. (Stip. #18)

8. On September 22, 1998, the taxpayer filed its first amended 1994 income tax return, its second amended 1995 income tax return, and its second amended 1996 income tax return. These amended returns reflected a carry back of the net operating loss from the 1997 return. The amended returns showed an overpayment for 1994 of \$27,497 and for 1995 of \$10,106, and a tax due of \$36,843 for 1996. (Stip. #27, 37)

9. The taxpayer included a cover letter with its amended returns for 1994, 1995, and 1996. The letter stated that the reason no payment was included with the August 1998 filing of the 1995 and 1996 first amended returns was because the taxpayer expected the 1997 net operating loss to offset any additional tax due. (Stip. #38)

10. On October 13, 1998, the Department acknowledged receipt of the returns and indicated that the returns would be processed on a first in first out basis. (Stip. #28)

11. On November 20, 1998, the Department issued a check to the taxpayer in the amount of \$56,960.43. This was a refund for the \$55,000 overpayment of estimated tax payments relating to the taxpayer's 1997 return, plus interest. (Stip. #20)

12. On March 12, 1999, the taxpayer timely filed its 1998 Form IL-1120. The return showed a tax due of \$43,718, and the taxpayer computed an estimated tax underpayment penalty of \$7,868. (Supplemental Stip.)

13. On August 23, 1999, the Department sent a notice to the taxpayer regarding its 1998 income tax return. The notice indicated that the taxpayer had an overpayment of \$22,868 and a penalty for failing to make sufficient estimated payments during the 1998

tax year. This penalty is known as an 804 penalty and was in the amount of \$5,901.93. This left a total overpayment of \$16,966.07. (Stip. #29, 39)

14. On July 21, 2000, the Department notified the taxpayer that it owed a late payment penalty of \$7,154.70 with interest of \$1,977 for failing to pay a balance of \$16,842.44 for its 1996 income tax return.¹ (Stip. #40)

15. On August 2, 2001, the taxpayer filed a third amended return for 1996 and a first amended return for 1998. The third amended 1996 return showed the penalty of \$7,155 for 1996 as paid, but claimed a refund for that same amount. The amended 1998 return showed the 804 penalty of \$5,902 as paid, but claimed a refund for that same amount. (Stip. #41)

16. On October 4, 2001, the Department issued Notices of Denial for the third amended 1996 return and the first amended 1998 return. (Stip. #42)

CONCLUSIONS OF LAW:

The Department imposed the late payment penalty for the 1996 income tax return pursuant to section 3-3(b) of the Uniform Penalty and Interest Act (UPIA) (35 ILCS 735/3-1 et seq.), which provides in part as follows:

“A penalty of 15% of the tax shown on the return or the tax required to be shown due on the return shall be imposed for failure to pay:

(1) the tax shown due on the return on or before the due date prescribed for payment of that tax, an amount of underpayment of estimated tax, or an amount that is reported in an amended return other than an amended return timely filed as required by subsection (b) of Section 506 of the Illinois Income Tax Act” (35 ILCS 735/3-3(b))

Section 3-8 of the UPIA provides a basis for the abatement of the section 3-3 penalty and states in part as follows:

¹ Taxpayer’s Exhibit #4, p. 54 indicates that the balance of \$16,842.44 includes the penalty of \$7,154.70 and interest of \$1,977.

“The penalties imposed under the provisions of Sections 3-3, 3-4, and 3-5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department.” (35 ILCS 735/3-8)

The Department imposed the penalty for the estimated tax underpayment for the 1998 return pursuant to section 804 of the Income Tax Act (35 ILCS 5/1 et seq.) Section 804 provides that the penalty under that section “shall not be imposed to the extent that the Department or his designate determines pursuant to Section 3-8 of the [UPIA] that the penalty should not be imposed.” (35 ILCS 5/804(e)) To help determine whether the taxpayer has established reasonable cause under section 3-8 of the UPIA, the Department promulgated a regulation concerning reasonable cause that provides in part as follows:

“The determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion.” 86 Ill.Admin.Code §700.400(b)

1996 Penalty

The taxpayer argues that the late payment penalty in the amount of \$7,154.70 that was assessed against the taxpayer’s 1996 return should be abated because the taxpayer had an overpayment for its 1997 return at the time that the 1996 payment was due. When the 1996 amended return was due on July 14, 1998, the taxpayer owed \$51,983 for its 1996 liability, but at the same time the taxpayer had an overpayment with respect to its 1997 return in the amount of \$55,000. The overpayment should have been applied to the 1996 liability before the Department issued the refund on November 20, 1998. In addition, the taxpayer notes that the letter that it sent to the Department on September 22,

1998 stated that no payment was included with the 1996 amended return because the taxpayer expected the 1997 loss to offset any additional tax due.

The taxpayer contends that the taxing statutes and the Department's regulations support a finding that the penalty should be abated. Section 909 of the Income Tax Act provides in part as follows:

“(a) In general. In the case of any overpayment, the Department may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of the tax imposed by this Act, regardless of whether other collection remedies are closed to the Department on the part of the person who made the overpayment and shall refund any balance to such person.” 35 ILCS 5/909.

The taxpayer notes that similar provisions are also found in the Civil Administrative Code, 20 ILCS 2505/39e², and the Department's regulation concerning credits and refunds, 86 Ill.Admin.Code §100.9400(a). In addition, the taxpayer notes that section 3-3(c) of the UPIA requires the tax to be reduced by any allowable credit before determining the late payment penalty. That provision states as follows:

“For purposes of the late payment penalties, the basis of the penalty **shall** be the tax shown or required to be shown on a return, whichever is applicable, **reduced by any part of the tax which is paid on time and by any credit which was properly allowable on the date the return was required to be filed.**” 35 ILCS 735/3-3(c) (emphasis added).

The taxpayer argues that under these statutory and regulatory provisions, the Department should have credited the \$55,000 overpayment for 1997 to the 1996 liability, and the penalty should be reduced to zero. In the alternative, the taxpayer suggests that the overall circumstances of this case warrant abating the penalty; the Department did not suffer any damage because it had the 1997 overpayment at the time that the 1996 payment was due.

² The citation for this provision is now 20 ILCS 2505/2505-275.

The Department contends that because the taxpayer did not file its 1996 amended return by July 14, 1998, the Department had no alternative to imposing the penalty, regardless of the effect of section 909, because payment of the correct amount of tax for 1996 was due on March 15, 1997. The Department states that neither the statutes nor the regulation **mandate** the Department to do anything; they simply state that the Department **may** credit overpayments to other liabilities. The Department contends that its position is supported by the case of Dow Chemical Co. v. Department of Revenue, 224 Ill.App.3d 263 (1st Dist. 1991), where the court said that section 909 does not enhance a taxpayer's ability to require the Department to credit a time-barred overpayment against the taxpayer's future liability. The Department claims that it is not required to give the taxpayer credit for the overpayment, and even if it were, overpayments were not available on March 15, 1997, which was when the liability became due absent a timely filed federal change amended return.

The taxpayer also claims that the 1996 penalty was not properly calculated. Section 3-3(b) states that the penalty is 15% of the tax shown on the return, and under section 3-3(c), the tax is to be reduced by any part of the tax that is paid on time and any credit that is properly allowable on the date the return was required to be filed. After the filing of the taxpayer's amended returns for 1994, 1995, and 1996, there were overpayments for 1994 and 1995 in the amounts of \$27,497 and \$10,106. The Department applied the 1994 and 1995 overpayments to the 1996 tax year. (Taxpayer Ex. #4, p. 54) The Department applied \$24,961 from the 1994 return and \$10,183 from the 1995 return.³ The total amount of tax due on the 1996 amended return that was filed

³ It is not clear from the record why these amounts are different from the amounts on the amended returns. The taxpayer apparently agrees with the amounts that the Department applied.

on September 22, 1998 was \$87,415. On March 17, 1997, the taxpayer had paid a total of \$50,570 towards its 1996 liability. This left an additional \$36,845 that was owed for the amended tax return. On May 26, 1998, the taxpayer had filed its 1997 return that showed a net operating loss. The taxpayer contends that the overpayments for 1994 and 1995 that resulted from the net operating loss carryback should have been credited to the taxpayer's account as of March 15, 1998, which was the due date for the return. After applying the 1994 and 1995 overpayments to the balance of \$36,845, only \$1,701 remains due for the 1996 return. The taxpayer contends that the penalty should be calculated on this amount.

The Department contends that the taxpayer's argument concerning the calculation is simply a reassertion of the contention that the overpayments should have been applied to reduce the amount of tax due. The Department argues that the statutes and regulations determine the timing of the credits, and they do not support the taxpayer's payment scenarios. The Department states that the 1994 and 1995 overpayments were allowable as of September 22, 1998, which was when the 1994 and 1995 amended returns were filed. This was more than two months after the due date of the 1996 amended return, which was July 14, 1998.

The Department notes that although it did eventually credit the 1994 and 1995 overpayments to the 1996 liability, the 1996 liability included the penalty that is under protest in this case. The Department claims that it is disingenuous of the taxpayer to argue that the crediting of the overpayments to 1996 after all the calculations were finalized should somehow reduce the liability. In addition, the 1994 and 1995 amended returns indicate that the taxpayer directed the Department to refund the overpayments.

(Taxpayer Ex. #4, pp. 31, 34) The Department claims that this raises a question as to the sincerity of the taxpayer's assertion that the Department should have credited the overpayments to the 1996 liability.

Section 3-3(c) of the UPIA states that the basis of the late payment penalty shall be the tax shown on the return, reduced by any tax that was paid on time and by any credit that was properly allowable on the date the return was required to be filed. (35 ILCS 735/3-3(c).) The Department contends that in the absence of a timely filed amended return, the 1996 return was required to be filed on March 15, 1997, and this is the date that should be used for determining the tax that is the basis of the late payment penalty. The penalty, however, was imposed for the late payment that resulted from the amended return, which was required to be filed on July 14, 1998. This is the date that must be used to determine the tax, and the tax must be reduced by any credit that was properly allowable on July 14, 1998.

Although the taxpayer was entitled to a refund of \$55,000 on July 14, 1998, this was not a credit that was "properly allowable" under section 3-3(c) because the taxpayer had requested that the money be refunded. The taxpayer did not request that the money be credited to its future liabilities. As the Department has indicated, section 909(a) of the Income Tax Act does not require the Department to credit any overpayment against a tax liability. This provision simply states that the Department "may" do this. (35 ILCS 5/909(a).) The Department was not required to apply the \$55,000 overpayment to the 1996 liability. When the taxpayer filed its 1997 return, it requested that the overpayment

be refunded instead of credited to its future liability.⁴ In November 1998, the Department refunded the money as the taxpayer had requested. In Dow Chemical Co., the court indicated that there is no limitation on the Department's authority to make a refund or credit, but there is a limit on the taxpayer's ability to file for one. Dow Chemical Co. at 267. From that reasoning, it follows that there is a limit on the taxpayer's ability to receive a credit. In this case, the taxpayer is entitled to receive only what it requests. Because the taxpayer requested that the \$55,000 be refunded instead of credited to future liabilities, the Department was not required to apply the \$55,000 to reduce the 1996 liability.

Similarly, the Department was not required to apply the credits from the 1994 and 1995 amended returns to the 1996 liability to determine the amount of tax that should be the basis of the penalty. On July 14, 1998, when the taxpayer was required to file the 1996 amended return, the taxpayer had not yet filed any returns that carried back the NOL. Any benefit that the taxpayer could receive from the NOL did not yet exist in July because the benefit does not exist until the taxpayer actually requests it. The taxpayer must affirmatively act in order to receive the benefit of the NOL. The taxpayer's claim for the credit from the NOL carry back did not ripen until the amended returns requesting it were filed. The taxpayer could have completely lost the benefit of the NOL if it had never filed the amended returns and applied it to prior years. Dow Chemical Co. *supra*. The Department cannot anticipate what the taxpayer will do until it actually does it. Because the taxpayer had not requested the NOL carry back on July 14, 1998, the Department properly calculated the penalty based on the tax due as of that date.

⁴ The parties stipulated that the 1997 return claimed an overpayment of estimated tax totaling \$55,000 (Stip. #32, 33), but the copy of the return that was attached to the stipulations does not show an estimated

The facts of this case also do not warrant abating the late payment penalty due to reasonable cause. The most important factor to consider in deciding whether the taxpayer acted with reasonable cause is the extent to which the taxpayer made a good faith effort to determine his tax liability and to file and pay it in a timely fashion. (86 Ill.Admin.Code §700.400(b).) The only reason provided by the taxpayer as to why it did not timely pay its 1996 liability was that the taxpayer expected the 1997 NOL to offset any additional tax due. The taxpayer knew of the NOL in May of 1998 and had an accountant who was preparing its returns. Prior to the due date of the 1996 amended return, the taxpayer would have known that the NOL would not totally cover the 1996 liability. When the NOL was carried back, the taxpayer still owed \$36,843 for its 1996 liability. Even after the credits from the 1994 and 1995 amended returns were applied to the 1996 liability, the taxpayer still owed \$1,701. The taxpayer did not give any explanation as to why even the \$1,701 was not timely paid in July of 1998. Five days after the 1995 and 1996 amended returns were due, the taxpayer sent the Department a letter indicating that it was in the process of completing the returns, but did not give a reason for the delay and no payment was sent with that letter. The taxpayer could not have expected the \$55,000 overpayment from the 1997 return to cover the liability because it had asked for the \$55,000 to be refunded. The taxpayer should have known that a payment should have been made by July 14, 1998. These facts do not warrant abating the penalty.

1998 Penalty

With respect to the 1998 estimated tax underpayment penalty, on March 12, 1999, the taxpayer timely filed its 1998 Form IL-1120. At that time, the taxpayer computed a

tax overpayment. (Exhibit #5, pp. 20-22)

tax due in the amount of \$43,718 and an estimated tax underpayment penalty of \$7,868, for a total due of \$51,586. On August 23, 1999, the Department sent the taxpayer a notice advising that the taxpayer had an estimated tax underpayment penalty in the amount of \$5,901.93 for its 1998 return, which was \$1,966.07 less than what the taxpayer had calculated. At the same time, the Department advised the taxpayer that it was entitled to a refund of \$16,966.07 because the Department had applied two payments to the taxpayer's 1998 return: the first payment was for \$15,000 on December 8, 1998 and the second was for \$51,586 on March 15, 1999. The \$15,000 payment and the penalty reduction of \$1,966.07 resulted in an overpayment of \$16,966.07.

The taxpayer states that as of September 22, 1998, the taxpayer had overpayments with respect to its 1994 and 1995 amended returns in the amounts of \$27,497 and \$10,106 respectively, and on October 13, 1998, the Department notified the taxpayer that the returns would be processed on a first in first out basis. The taxpayer contends that the 1994 and 1995 overpayments should have been applied first to 1998, which would have significantly reduced the amount of the estimated tax underpayment penalty for that year.

The taxpayer cites section 909(b) of the Income Tax Act, which provides as follows:

“(b) Credits against estimated tax. The Department may prescribe regulations providing for the crediting against the estimated tax for any taxable year of the amount determined by the taxpayer or the Department to be an overpayment of the tax imposed by this Act for a preceding taxable year.” 35 ILCS 5/909(b).

In addition to requesting that the overpayments be applied to the 1998 year, the taxpayer argues that the overall circumstances of this case warrant abating the 1998 penalty.

The Department argues that section 909(b) does not direct the Department to credit overpayments to estimated tax balances; section 909(b) merely allows the

Department to issue regulations that would allow crediting overpayments to estimated tax balances. The Department's regulation relating to section 909(b) provides as follows:

“Credit against estimated tax. An individual or corporate taxpayer by filing a return for the taxable year using the appropriate form and checking the appropriate box thereon in accord with the instructions shall have the amount of any overpayment or portion thereof credited thereafter against his estimated tax liability for the next succeeding taxable year.” 86 Ill.Admin.Code §100.9400(b).

The Department argues that this regulation requires the taxpayer to use the proper form to direct the overpayment to the estimated tax balance only for the next succeeding taxable year. The Department states that the taxpayer did not direct the Department to use the 1994 and 1995 overpayments for the 1998 estimated tax liability, and did not use the proper form to do so. In addition, 1998 is not the next succeeding taxable year to either 1994 or 1995. The Department contends that because the taxpayer did not perform the two elements required by the regulation, the penalty should not be abated.

The taxpayer responds that the penalty was apparently calculated on the basis that the taxpayer did not make estimated payments in the amount of \$9,835 on April 15, 1998, \$9,837 on June 15, 1998, and \$9,837 on September 15, 1998. This totals \$29,509 and 20% of that amount equals \$5,901.80. The taxpayer claims that the 1994 overpayment of \$27,497 was available as of March 15, 1995, and the 1995 overpayment of \$10,106 was available as of March 15, 1996. The taxpayer argues that the taxpayer had more than enough credit to cover the estimated payments.

The Department notes that the taxpayer wants the same 1994 and 1995 overpayments that it wanted credited to its 1996 liability to be credited to the 1998 estimated tax. Because the overpayments cannot be credited to both years, the

Department contends that this argument is a sign of the fundamental weakness of the taxpayer's position.

The facts support a finding that the estimated tax underpayment penalty was properly imposed. As the Department has indicated, section 909(b) simply authorizes the Department to prescribe regulations that allow crediting overpayments to the estimated tax. The Department's regulation in response to this section allows an overpayment to be credited to the estimated tax liability for the next succeeding tax year if the taxpayer files a return using the appropriate form and checking the appropriate box. The 1994 and 1995 amended tax returns include a line for a refund of any overpayment, and that line specifically states that "Overpayments **cannot** be credited to estimated tax." (Taxpayer Ex. #4, pp. 31, 34, line 8) The 1994 and 1995 amended returns were not the appropriate forms for requesting that the overpayments be applied to the 1998 estimated tax liability, and the Department did not err by failing to apply the overpayments to the liability.

In addition, the facts do not warrant abating the estimated tax underpayment penalty due to reasonable cause. In September 1998, the taxpayer believed that the 1994 and 1995 overpayments would offset any additional liability due for 1996. It is not reasonable to believe that those same overpayments would be used towards its 1998 estimated tax liability. The taxpayer did not show how it made a good faith effort to pay its estimated tax liability and did not provide any explanation as to why it failed to make estimated payments on April 15, June 15, and September 15 of 1998. The 1997 return with the net operating loss was not filed until May 26, 1998, so the taxpayer was not even aware of any potential overpayment at the time that the first estimated tax payment was

due. The taxpayer timely made its fourth payment even though it had overpayments at that time. These facts do not support an abatement of the penalty.

Recommendation:

For the foregoing reasons, it is recommended that both the 1996 penalty and the 1998 penalty be upheld.

Linda Olivero
Administrative Law Judge

Enter: February 18, 2003